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C O N F I D E N T I A L ROME 003697

SIPDIS

PARIS FOR USOECD, FRANKFURT FOR WALLAR

E.O. 12958: DECL: 08/14/2008
TAGS: ECON EFIN PGOV IT
SUBJECT: ITALY'S BUDGET BATTLE BEGINS (CORRECTED VERSION - PARAGRAPH NUMBERING)

REF: ROME 2853

Classified By: Economic Counselor Karen Milliken for reasons 1.5 (b, d)

¶1. (SBU) Summary. The release of the government's four-year economic blueprint (DPEF) has started off Italy,s annual budget process with a bang. The DPEF, which sets budgetary guidelines for the upcoming year and makes projections about economic performance, was a carefully crafted compromise among feuding coalition partners. The result, nonetheless, triggered controversy and finger pointing. Italy,s Central Bank Governor and leading industrialists harshly criticized the Berlusconi government for the DPEF,s failure to address the need for structural reforms and for making what they say are unfounded claims about a positive economic performance.

¶2. (SBU) While not binding, the DPEF is normally a preview of the final budget package. Players in the political process are scrutinizing the DPEF for insight into the government,s economic priorities. With its publication, they have begun their posturing to ensure that, at the end of the day, the budget preserves their special interests. The DPEF also was caught up in political tensions within the ruling coalition. There's a heated dispute among coalition partners on spending, reforms and the direction economic policy should take.

¶3. (U) Even the Italian government admits in the DPEF that Italy is unlikely to balance its budget before 2007, while GDP growth rates are expected to hover between two percent and 2.6 percent in the four-year period. Noticeably absent from the DPEF are any government plans to privatize key state-owned business, or for tax and pension reform. End Summary.

The Basic Facts: DPEF 2004-1007

¶4. (U) On July 17, the Berlusconi Government presented to Parliament its financial plan) Documento di programmazione economica e finanziaria (DPEF) - for 2004-2007, which was reviewed by Parliament before it adjourned for the August summer recess. The plan outlines the parameters for the annual budget for 2004, which will be presented to Parliament in late September.

¶5. (U) The key targets of the DPEF are:

-- Real GDP growth of 0.8 percent in 2003 and two percent in 2004, increasing gradually to 2.6 percent in 2005-2007.

-- Steady reduction of Italy's high debt from 105.6 percent of GDP in 2003 to 104.2 percent in 2004 and to 97.1 percent in 2007. (Note: Last year,s DPEF predicted a drop in Italy's debt to 95 percent of GDP in 2007. End Note).

-- Stable inflation under 2 percent per year. Inflation is expected to decline from 2.5 percent in 2003 to 1.7 percent in 2004, to 1.5 percent in 2005 and 1.4 percent in 2006 and ¶2007.

-- Lower unemployment, expected from an economic recovery combined with measures designed to increase labor market flexibility, from 8.8 percent in 2003 to 8.2 percent in 2004 and 7.5 percent in 2007. The GOI also plans to increase the labor participation rate to close to 60 percent in 2007. (Note: The target has been postponed by one year. Last year,s DPEF predicted that the 60 percent target for the labor participation rate would be achieved in 2006. End note).

-- Investment in physical capital, human capital and technology, aimed at raising productivity and competitiveness.

-- Implementation of macroeconomic and financial policies that are in line with the European Stability and Growth Pact commitments.

-- Increased investment in infrastructure, both through the Tremonti-proposed Euro-wide project and through domestic initiatives. The GOI has allotted 32 billion Euro for infrastructure projects in the period 2003-2006.

The problem with the numbers

¶6. (SBU) The government,s GDP growth target for 2003 of 0.8 percent is, according to some analysts, still too optimistic.

The latest consensus forecast assumes 0.6 percent growth this year and 1.6 percent growth in 2004. Comment: The government's projected growth rate would be possible only if there were a global economic recovery in the second half of the year, which at this moment seems unlikely. End Comment. In the period 2004-2007, the GOI predicts a GDP growth rate ranging from two percent to 2.6 percent.

¶7. (SBU) The GOI expects 2.4 percent inflation for 2003, which many analysts also believe is unrealistic. This prediction is 20 basis points below the latest data available (2.6 percent in June), 30 basis points below the average of the first half of the year (2.7 percent) and 10 basis points below the latest consensus estimates (2.5 percent).

¶8. (SBU) The DPEF does not specify what spending cuts and revenue raising measures will be proposed in the 2004 budget. The DPEF also does not identify any government plans to sell off state-owned companies in the short term. In the last ten years, the GOI raised USD135 billion through privatizations, which helped reduce the debt/GDP ratio from 125 percent to 106 percent of GDP. End note. As it has argued previously, the GOI contends in the DPEF that it is delaying selling off companies because of uncertain market conditions.

¶9. (SBU) Comment: Even when market conditions improve, we do not expect the government to sell off its most valuable assets. Reluctant to sell shares of firms in sectors considered to be critical to national security, such as aerospace and defense, the GOI is likely to hold on to its 32.3 percent stake in Finmeccanica (the large aerospace and defense holding company), 67 percent stake in Enel (Italy,s main electrical producer) and 30 percent stake in ENI (Italy,s largest hydrocarbon company). The GOI also is not considering sale of RAI (radio and TV broadcasting) or Alitalia (national airlines.) Both entities are over-staffed, money losers. End Comment.

Controversy Erupts

¶10. (SBU) With the DPEF,s release, a long-brewing squabble between Finance Minister Tremonti and Central Bank Governor Fazio bubbled over. The DPEF was the ostensible reason for the spat, with Fazio harshly and publicly criticizing the DPEF for ignoring the need for major structural reforms. However, the dispute,s roots went much deeper.

¶11. (SBU) Although initially enthusiastic about the Berlusconi government's economic program, Fazio has become increasingly disenchanted with the government writ large, but, most pointedly, with Tremonti. Fazio has criticized the government for not tackling more seriously the need for structural reforms, including pension and tax reforms, and for consistently projecting a positive economic performance, which he argues, is unfounded. Fazio,s criticism is shared by many, including Antonio D,Amato, president of Italy,s largest business confederation, who argued that the Italian government has not done enough to improve Italy,s competitiveness and to address major structural problems.

¶12. (C) Comment: The position of the Central Bank Governor is traditionally a "neutral8 voice in economic policy making. Fazio, many believe, has personal political aspirations to become Finance Minister and so is distancing himself from the Government's policies. Tremonti has argued that Fazio's inaction to protect Italian investors and consumers requires systemic change to take away some of the Central Bank's banking supervisory authority, a challenge to one of the few independent functions still exercised by the Bank of Italy.

¶13. (C) Comment continued: There has been a lot of jockeying in the ruling coalition over who has the upper hand in economic policy making. Tremonti, a technocrat firmly linked to coalition partner Northern League, still has the lead, but National Alliance (AN) and the Union of Christian Democrats of the Center (UDC) recently pushed hard for a greater role in economic policy making, complaining of being presented with faits accomplis in meetings of the Council of Ministers. Some ministers also are complaining that they have no extra funds for "politically necessary" expenditures. A proposal by Berlusconi to create a mini-cabinet under the direction of Deputy Prime Minister Fini to coordinate economic policy making was overturned. But AN and UDC laid down markers that they expect to be given decision-making power in the run-up to the final budget package. The DPEF was a compromise document carefully crafted to keep the coalition in line in the face of these tensions.

Other voices of criticism

¶14. (SBU) Labor unions reacted coolly to the plan, despite the GOI offer to discuss the labor issues contained in the DPEF. The opposition, as expected, criticized it. Banking lobbies, forced the GOI to delete provisions regarding home mortgages.

The last time?

¶15. (U) Given this year,s controversy over the DPEF and the questionable utility of this annual exercise, Finance Ministry Tremonti has called for a much different DPEF next year. Pointing out that only Italy goes through this annual exercise, Tremonti has said the 2004 DPEF will be reduced to just one page. Budget details will only be revealed in the presentation of the budget each September before Parliament.

Final Comment

¶16. (SBU) The DPEF, while just a planning document, demonstrates how difficult it will be to enact major structural changes. Even mention of the need for such reforms was struck out at the last minute based on some coalition partners' objections. Already various political parties, industrial associations and labor unions have put the government on notice that they expect more from the final budget package in terms of growth initiatives. Recent indications that Italy is now officially in recession for the first time since 1992 (the economy has shrunk over two quarters) will fuel this clamor. Yet many of these groups have fought hard against needed tax, labor and pension reforms.

¶17. (C) The August vacation season has stilled the controversy over the DPEF. The battle will begin again with the September presentation of the budget to Parliament, with attention focusing on Finance Minister Tremonti. Embattled for several months, Tremonti seems to have held his ground, although resentment of what is perceived as his high-handed style lingers, as do real differences among coalition partners toward the way ahead for Italy's economy. The question remains whether the intra-coalition struggle will challenge Tremonti's staying power and his pro-reform policies. His coalition opponents see the clocking ticking toward spring elections, are hungry for more budgetary flexibility to permit "political expenditures." Once again, in Italy, it is politics as usual. End Comment.
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